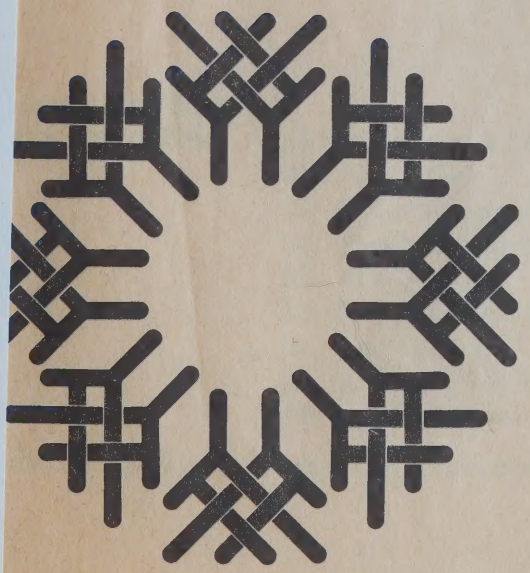
he New Federal
ax Proposals for Charities:

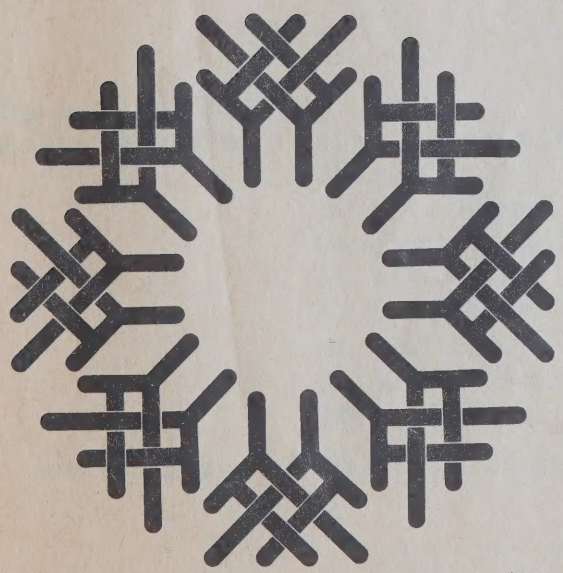
A Response from
he Canadian Centre
or Philanthropy



The Canadian Centre for Philanthropy

The New Federal Tax Proposals for Charities:

A Response from The Canadian Centre for Philanthropy



The Canadian Centre for Philanthropy

A submission by the Board of Directors of The Canadian Centre for Philanthropy

The Legislative Watch Ad Hoc Committee:

Mr. Ian Morrison *Chairman*
Mr. Allan Arlett
Mr. Colin Graham, F.C.A.
Mr. Alex Langford, Q.C.
Mr. Alan Martin
Mr. John McKellar, Q.C.
Mr. John Pollock
Mr. Kevin Sullivan, C.A.
Mr. Gerald Wright

with the assistance of Mr. Wolfe D. Goodman, Q.C., S.J.D.

August 3, 1983

Response and the information provided at the seminars in preparing their own submissions.

The publication, produced in both English and French, has been made available to all Associates of the Centre and to all of those who participated at the seminars.

The Ad Hoc Committee is comprised of individuals from major charities and legal and accounting firms, who volunteered their time and expertise to analyse, evaluate and prepare a response for the Board of Directors of the Centre. We would like to extend our thanks to all those involved in this preparation.

The Canadian Centre for Philanthropy works to encourage philanthropy throughout Canada; our success in achieving this aim is due to the financial support received from our Associates, foundations and corporations and to the efforts of dedicated volunteers who are willing to share their time and expertise.

Allan Arlett
Executive Director
The Canadian Centre for Philanthropy

EXECUTIVE SUMMARY

The Canadian Centre for Philanthropy has carefully studied the comments and draft legislation contained in Charities and the Canadian Tax System, the Discussion Paper released by the Department of Finance on May 17, 1983, and the complete text of its comments is enclosed herewith.

While agreeing with the Department's stated goals and objectives, the Centre disagrees with many of the legislative provisions designed to attain them. What follows is a summary of the Centre's major areas of concern and its recommendations:

Extreme Complexity

The complexity of the proposals will lead to frustration and unnecessary expenditures of time and professional fees. If the proposals are not simplified, publication of an accompanying explanatory guide will be essential.

Single Registration System

In order to avoid unnecessary complexity, the distinctions among the three types of charitable entities should be maintained.

Use of Property

A charity should be permitted to make its property available to employees who are involved in its charitable activities or to members who are in need.

Non-Receipted Gifts

Gifts made to a charity for which the donor has not received an official tax receipt should not be included in the charity's income for the purposes of the disbursement quota.

Definition of "Gift"

The word "gift" should be defined, and should not include Government grants.

TABLE OF CONTENTS

		Page
I	INTRODUCTION	1
II	SUBMISSIONS	5
1.	Extreme Complexity	5
2.	Single Registration System	7
3.	Use of Property	10
4.	Non-Receipted Gifts	12
5.	Definition of "Gift"	13
6.	Testamentary Gifts	14
7.	Penalty Tax	14
8.	"Related Charities" and "Major Donors"	16
9.	Disbursement Quota	21
10.	Accumulation Rules	26
11.	Qualified Disbursements	26
12.	4.5% Rule	27
13.	Rate of Return on Non-Qualified Investments	29
14.	$250,000 Threshold	29
15.	Related Business	29
16.	Control of a Business Corporation	31
17.	Deadline for Annual Filing	34
18.	Gifts to Non-Residents	34
III	CONCLUSION	36

I INTRODUCTION

The Canadian Centre for Philanthropy ("the Centre") agrees with the Department of Finance ("the Department") that charities should be subject to reasonable regulation to ensure that they act for the public good, since the purposes of charities are public ones and the Department is charged with a stewardship role for this public interest. Very few of the charities consulted by the Centre since publication of the Department's Discussion Paper on May 17, 1983 have taken exception to this principle.

The Centre endorses the following statements contained in the Discussion Paper:

> [These] proposals ... seek to promote the long-standing public policy of providing a tax environment in which charities can thrive and make their valued and essential contribution to the health and well-being of our Canadian society. The proposals seek, at the same time, to meet the public interest of ensuring that the charitable donations and investments being encouraged through substantial tax benefits are disbursed, in fact, for charitable purposes.
>
> . . .
>
> Organized charity has long played a significant role in the development of Canadian society. Throughout the years, numerous foundations and charitable organizations have benefitted Canadians and people of other countries by assisting the poor, encouraging education, funding scientific and medical research, furthering religious study and awareness, supporting cultural activities and contributing to the general development of our communities.
>
> The Government of Canada has long been committed to encouraging charities in this role, providing them with an environment in which they can grow and flourish. (at pp. iii and 1)

Further, the Department has recognized, in the Discussion Paper and the accompanying draft legislation, the need for charitable foundations (and charitable organizations with endowments) to conserve capital in an inflationary environment, while insisting on appropriate disbursement requirements.

While the Centre can therefore support the underlying purposes of the Discussion Paper, this support does not extend to the proposed methods of implementation.

Based upon its consultation with affected Canadian organizations in all parts of the country, the Centre can report extremely strong concern, even alarm, over much of the draft legislation that accompanies the Discussion Paper. This deep concern has been reinforced by the findings of an Ad Hoc Committee of the Centre's Board of Directors, which has met on several occasions since the release of the Discussion Paper for purposes of analysis and review. The following submissions were prepared by the Committee for the Board's consideration and are based upon both the Committee's independent analysis and input received from a series of seminars held in Toronto, Halifax, Montreal, Winnipeg, Calgary, Edmonton and Vancouver from June 15 to June 30, 1983. Comments from some of the almost 1000 participants at these seminars, as well as relevant quotes from other sources, are inserted at appropriate points throughout the submissions.

The Centre wishes first of all to remind the Department of the size of the problem facing both the Government and the charitable community in Canada in meeting the goals behind the proposed legislative changes. The charitable section in Canada is both diverse and extensive.

Consider:

- There are 47,000 registered charities in Canada, compared with only 33,000 manufacturing concerns.
- Excluding universities, teaching institutions and hospitals, charities in Canada took in $5.6 billion in 1980, equivalent to 11% of all Federal Government revenue, or almost 2% of GNP.
- The wage bill of these charities in 1980 was $1.7 billion, estimated to compensate 173,000 persons, 23% of them on a part-time basis. This represents 1.6% of all employed workers in Canada, twice as many as are directly employed in forestry, or one quarter of those employed in public administration by all levels of Government, or all employed workers in Newfoundland.

- 2.7 million Canadians volunteered 373 million hours of labour in 1979/80. If compensated at the average wage for the service sector, this would be worth $2 billion, almost as much as the agricultural sector's wage bill.

- Excluding universities, teaching institutions and hospitals, application of the value added concept to Canadian charities suggests this sector added $4.5 billion to Canada's output in 1980, or 1.7% of GNP.

- Trend data suggest that donations to the charitable sector increased by 100% from 1970 to 1981, while the consumer price index rose by 141%, a 31% drop in purchasing power.

Since all of this activity would be affected by the proposals contained in the Discussion Paper, their potential impact is both economic and social. The aggregate data, however, mask the diversity of the charitable sector. While the typical charity in Canada may be considered small in economic scale, employing only limited professional help and managed almost entirely by volunteer boards, the largest of our universities, hospitals and foundations are also charities. Charities concern themselves with a wide range of subjects, from health to education, environmental protection to international development, arts to spiritual development, youth service to social development, and constitute a force that is vitally important to Canada. Ill-conceived proposals for 'reform' can have substantial deleterious effects upon this sector, many of them no doubt unforeseen and more serious in some parts of the charitable sector than in others.

Statistics show a startling decline in recent years in philanthropic activity in Canada:

- in 1961, 24.5% of Canadian taxpayers claimed charitable donations of more than $100; in 1980 just under 10.3% claimed

- a 1977 study found that 52% of voluntary associations queried had great difficulty raising the funds necessary for their operations

- a 1981 study showed that only 15% of adult Canadians donated their time to volunteer causes

- in the past two years foundation assets have been eroded by inflation and falling investment income and corporate giving has remained, at best, on a plateau

The Centre urges the Department to listen carefully to the criticisms that it will receive. The health of this sector is important to the Canadian economy, to the country's social harmony and even to its democratic way of life. Furthermore, a sector that depends entirely upon voluntary donations of time and funds is, of necessity, fragile, and it therefore falls to public policy to extend special consideration and support to the voluntary sector. This is the Department's stewardship responsibility to the Canadian public.

The most serious criticism of the proposals is their extreme complexity. Quite apart from a natural concern that provisions that are too complex and burdensome will divert energy from the true purposes for which Canada's charities were established, the Centre fears that this complexity will result in fewer volunteers, particularly at the board level.

Despite the claim of the authors of the Discussion Paper that the proposals "seek to ... simplify the system" (at p.3), the proposed rules, if adopted, would, in the opinion of some experts, place the taxation law for charities on a plane of complexity equal to that facing small business in Canada, and greater than that facing big business. The concern over this issue is widely shared in the charitable community, since most charities do not have access to professional assistance or advice in the daily conduct of their financial affairs.

In order to deal with the reality of the charitable sector of the 1980's and to fulfill the Government's expressed intention to reduce the 'paper burden', there must be a fundamental change in the Department's perspective. Once this is accomplished and more appropriate legislation is introduced, an extensive program of public education will be needed to assist the many responsible volunteer leaders in interpreting the tax

law amendments. This component of the proposed reform is of critical importance and must not be overlooked.

The participants in the Centre's cross-country seminars were urged to comment on the Department's original choice of August 15, 1983 as a deadline for consideration of the responses to the Discussion Paper. As a result of these comments and those made by the Centre and others, the Minister has announced an extension of the deadline to September 30, 1983. This is indeed welcome news. Particularly among the smaller charities, the Boards of Directors meet less frequently during the July/August period. Word of the existence of the Discussion Paper has only recently reached the grassroots of the potentially affected organizations. Perhaps reflecting its erroneous view that the proposals will affect only larger charities, the Department printed only 5,000 copies of the Discussion Paper and failed to respond to suggestions prior to its release that copies be sent to each of the 47,000 registered charities in Canada for comment and review. As a result, most charities have received no notification of the proposals. There has been little publicity, other than coverage of the Centre's seven regional meetings held in co-operation with the Federation of Junior Leagues of Canada.

II SUBMISSIONS

1. Extreme Complexity

The Government's policy of attempting to ensure that both registered charities and the general public are well served by private philanthropy has resulted in complex rules that seek to eliminate all of the "defects" of the present legislation and, at the

same time, to "simplify the system". While dealing with valid concerns, the new proposals come at a time when those involved with Canadian charities have only begun to understand the existing legislation, and further confusion is bound to result in several areas. For example, the complexities and technicalities of several provisions could result in a charity unknowingly having a "major donor" or even in two charities finding themselves "related". Once "related", many of their activities would then be subject to Ministerial discretion, a nebulous concept at best. In addition, the requirement that gifts from related charities are to be disbursed in the year of receipt could create serious problems for a charity that receives such a gift immediately prior to its year-end.

Other provisions that are confusing and therefore open to interpretation include those dealing with the valuation of assets and the disbursement quota.

These issues were discussed in June, 1983 by the almost 1000 participants in the Centre's cross-country seminars on the legislative proposals. Those participants included managers of charities, their legal and financial advisors, directors and volunteers, all of whom have made it their social responsibility to ensure that private philanthropy is well served in Canada, and all of whom expressed the view that, since most charities are staffed by volunteers and do not have the resources to hire full-time legal advisors, the rules should be kept simple and straightforward. Any abuses should of course be dealt with under the law, but attempting to legislate an end to all abuses is not only unrealistic and unmanageable but also unfair to the vast majority of charities.

"Working with volunteers and over-utilized and underpaid professional staff makes it difficult as the system is now, We don't need any added complexity... .

"We're going to spend most of our time looking over our shoulder and worrying about whether or not we are breaking the rules. We're going to spend less time on planning our programs and setting priorities."

Edmonton Seminar

"Small organizations voiced genuine concern that volunteers will gradually be turned off by the whole system if the bureaucracy becomes too complex. If volunteers are frustrated, it would frustrate the entire idea behind charitable organizations."

Halifax Seminar

"When people realize the complexity of these new provisions, they might be stopped from actually setting up charities."

Halifax Seminar

RECOMMENDATION: **If the Department insists upon enacting the proposals in their present complexity, publication of an accompanying "layperson's guide" will be essential in order that the representatives of Canada's 47,000 charities be given every opportunity to understand and comply with them.**

2. **Single Registration System** (s.149.1 (1) (a))*

The complexity of the proposed rules and the effect it will have on charities has been discussed. Much of this complexity would be avoided if the present legislative distinction between the two types of foundations and the charitable organizations were maintained.

It is the Centre's position that the three-track scheme currently in place broadly conforms to the realities of charitable institutions. While there is no doubt that a few foundations appear to operate as charitable organizations and some charitable organizations operate as foundations, the distinction between the two main categories of charities is clear and is reinforced by the manner of operation of the majority. Further, the distinction between a private and a public foundation is quite clear, being based on the source of funds and composition of the boards of directors.

The operational and philosophical differences between foundations and charitable organizations have not altered substantially since the last major change in the tax treatment of charities in 1977. Prior to the enactment of new legislation, Budget Paper D, released with the Budget of May 25th, 1976, eloquently defended the Department's view at that time that there should be a legislative distinction between the charitable entities:

> Charities in Canada are essentially of two kinds - active charities which provide services and carry out charitable activities; and foundations which distribute funds to be employed by others for charitable purposes. Foundations tend in turn to be of two types - those which are broadly representative, with donations received from the public at large; and those which are founded and controlled by one person or one family.

*Section numbers refer to the draft legislation.

It would appear that this view was still held by the Department as recently as November, 1981, when the Budget proposed that all charities be designated by the Minister as either foundations or charitable organizations. The Discussion Paper expresses concern over the fact that some charities change their status in order to minimize charitable expenditures. It is the Centre's contention that this "flip-flopping" was possible only because of the existing rule, which determines the classification of a charity by the percentage of its total expenditures in a year on

gifts to qualified donees. If this is correct, then the designation of each charity by the Minister would prevent the switching. Retaining the distinction between foundations and charitable organizations would permit the drafting of rules specifically designed to prevent abuses by entities within each of the specific categories.

"A very large concern has been expressed about the lumping of charitable organizations and foundations together. They are just not the same. The Federal Government must realize that by lumping all 47,000 charities together they must deal with any problems with one sector by dealing with all sectors. If a problem arises with a foundation, for example, it will impinge on a number of other people who are not related. It will cause all kinds of additional problems."

Calgary Seminar

While there are several large nation-wide charitable organizations and certain specialized groupings such as hospitals and educational institutions, most are, as stated earlier, modest in scope, largely staffed and operated by volunteers and usually very short of funds, having to rely on annual donations to stay afloat. The rules for charitable organizations should reflect the essential simplicity of the vast majority of them.

Most foundations are private ones, having been established by an individual or a family, and, while most are endowed, several have no assets and receive an annual donation from the founder or his or her family, which is to be expended in that year as gifts to qualified donees. The public foundations generally have endowments provided by a broad base of public support but still look to the public for contributions, which are either held as capital or distributed as gifts to qualified donees.

> "The foundations felt very strongly that the distinctions between the entities of the charitable organizations and charitable foundations should be maintained. If there needs to be a tightening up of rules, tighten them up for those specific groups, don't mingle everyone together.
>
> Montreal Seminar

After consulting charities across Canada, the Centre has concluded that many of the objections to the new provisions are based on the fact that the proposals, while aimed at problems apparently created by the private foundations, are to be applied, needlessly, to charitable organizations and public foundations as well.

RECOMMENDATION: **The distinctions in definition and rules among the various categories of charities should be maintained, and each charity designated by the Minister as either a foundation (public or private) or a charitable organization.**

3. **Use of Property** (s.149.1 (1) (a) (ii))

We commend the Department of Finance for its attempt to define charity in such a way as to take into account both the administrative practice of the Department of National Revenue and the "real world" in which charities operate. We are concerned, however, that subpara. 149.1 (1) (a) (ii) may be too restrictive, as it provides that no part of a charity's property is to be made available to an individual "who is a member, shareholder, trustee, settlor, officer, official, director or major donor thereof...". In particular we are concered that, under this proposal, an entity that would otherwise be a charity would be disqualified if it made low-interest or interest-free loans or

provided living accommodations to such persons as clergy, members of religious orders, professors and teachers, or even members who are in financial difficulty.

"Professors sometimes use their offices at the university for private research or consulting. Staff housing is often provided to members of staff of colleges and universities at a reduced rate. Students are receiving subsidy in the form of a reduced charge for the use of a dormitory since dormitories rarely pay for themselves. In the case of children of staff members there are situations in which tuition fees are waived or reduced or grants or loans may be made which are not necessarily governed exclusively by need; it may be simply by reason of the membership in the organization or employment by the organization or it may be, of course, simply on the basis of academic merit."

Toronto Seminar

"And in the context of religious groups, basically churches, where it could be said that all members of the community, or all members of that religion are members of the church and are members of that charitable organization, such a logical extension would create a situation where the bishop may be in receipt of a benefit for having a house provided to him. The charity may be off-side as a result. Another logical extension is that the church might not be able to carry out certain benevolent activities for its congregation because they are members of the church. I think we could go down to the basic example of individuals, the poor and needy especially, who are members of that congregation and want assistance from the church. In such cases, the church may be precluded from giving people either the food, the money or what have you."

Toronto Seminar

RECOMMENDATION: **Paragraph 149.1 (1) (a) should specifically provide that an entity will not fail to meet the definition of "charity" if the property is made available either to individuals employed by it and involved in its charitable activities or to its members, in pursuit of the charitable activities of the organization.**

While the public clearly expects Government to ensure that most tax deductible donations to charities are expended on charitable activities, this expectation is different for "non-receipted gifts", on which donors have paid income tax and no tax relief has been obtained. On such gifts, no tax revenue has been lost, and there is no logic in enforcing disbursement of these gifts.

While no doubt intended to curtail administrative and fund-raising costs, the proposed extension of the 80% disbursement rule to non-receipted gifts will place a great many of the 47,000 registered charities into a crippling "straitjacket".

4. **Non-Receipted Gifts** (s.188 (1) (b))

As a result, many charities will find that virtually their entire receipts will be subject to the disbursement rules and those that are less well-established will either be unable to accumulate reserves against future income shortfalls or expand their charitable activities in future, or, worse still, become subject to penalty taxes. For many, their dependence upon Government will be increased.

"We fail to see why donations for which a tax deductible receipt has not been issued should enter into the computation of a charity's disbursement quota. Since the donation is being made out of the donor's after-tax income, it ought to be of no concern to the Government how and when the charity spends it, as long as it is not used for a non-charitable purpose. In fact, non-receipted donations are often used, entirely properly, by charities to cushion the effects of fluctuating revenues and to enable them to maintain an appropriate level of service even when revenues have declined."

Toronto Seminar

RECOMMENDATION: **Disbursement rules should continue to be limited to gifts for which tax deductible receipts have been issued.**

5. **Definition of "Gift"**

Clarification is required on what constitutes a "gift". Are Government grants to be considered gifts? Are the proceeds of Daffodil Day or similar fund-raising ventures to be considered gifts or income from a product or service provided? A gift has been traditionally defined as, "the action or contract by which a person or group voluntarily transfers the ownership of a thing from himself/herself to another without the expectation of a receipt or an equivalent."

"If I, as a contributor on the street, purchase a daffodil for $1, and the cost of the daffodil or the value of the daffodil is 50¢, is the organization required to report the whole $1 proceeds as part of its disbursement quota, or is it to treat the 50% cost as a fund-raising cost, or is the 50¢ to be excluded from the income of the charity under the provisions.

"So there seems to be a number of alternatives for treating the different aspects of that $1."

Toronto Seminar

RECOMMENDATION: **The spirit of the above definition must be embodied in the Act, and neither transfers of funds for assessment allocations from local or Provincial bodies nor revenue received, from whatever source, in return for the provisions of specified services, should be included in the definition of a gift. In addition, Government grants should be continued to be treated as non-receipted donations, which, as we have already recommended, should not be included in the disbursement quota.**

6. Testamentary Gifts

The Department of Finance is commended for the exemption of most testamentary gifts from the disbursement rules. The success of charities in attracting testamentary gifts varies according to the charity's profile, and, as a result, it is important to exempt such gifts from inclusion in a charity's income.

7. Penalty Tax (ss. 188 (3), (4), (5), 160.3)

The Discussion Paper imposes a new Part V Tax on registered charities in certain circumstances. This means, unfortunately, that charities will be subject to the complete assessment, re-assessment, objection, appeal and review process. Because of the complexities, it is likely that the majority of the charities who, through mere inadvertence, may be liable for the tax, will be unaware not only of their liability but also their obligation to file the required return.

The proposed tax is to be applied automatically, without regard to the varied and changing circumstances of individual charities, most of which are comparatively small and unsophisticated and depend to a large extent on changing volunteer help.

The proposals do not take into account the fact that charities may not, by Provincial law, be permitted to make tax payments, particularly out of funds contributed for charitable purposes and that, if such payments are made, directors and trustees may be personally liable for the amount paid.

(Apparently, the regular $25.00 per day penalty imposed in s. 238 for failure to file returns would also continue to apply. This could result, on a yearly basis, in an additional $9125 in tax liability.)

> "It was suggested that this hundred and fifteen percent tax would effectively result in deregistration; it would not be an improvement but a step in the wrong direction. This tax might be of a more positive nature if a refundable tax is imposed, if sufficient distributions are not made. The tax would be levied and refunded when the distributions were made, as opposed to the rather negative incentive of further tax."
>
> Halifax Seminar

These comments are particularly relevant to the 100% tax imposed in s-s. 188 (4) in addition to the 15% tax imposed in s-s. (3). The total rate of tax (115%) smacks more of expropriation than regulation. Charities might be unable to make distributions within the allowable period and thereby incur tax liability for any number of reasons, some of which might include:

1. falling markets;
2. lack of liquid assets;
3. decreasing donations;
4. the proposed rule that non-qualified investments be valued at the greater of cost or fair market value;
5. the legal restrictions imposed upon the donee by the donor to the charity; and
6. charter or by-laws that prevent meetings to be held or a quorum found so that the charity can act quickly to authorize sales, liquidate, etc.

Further, where a charity that has made a gift to a related charity is subsequently assessed for the penalty tax, s-s. 160.3 (1) provides that the recipient charity is to be jointly and severally liable for the tax payable by the donor, to the extent of gifts received from it. While such a provision may be appropriate where one charity controls another or where both are under common control, it is unfair and unreason-

able where such control does not exist, and particularly where the recipient charity may have been unaware of the donor's failure to meet its disbursement quota and where the gift may already have been spent.

RECOMMENDATIONS: **The 15% tax should be refundable if the disbursement shortfall is subsequently made up, and any joint and several liability should be limited to situations of control.**

8. **"Related Charities" and "Major Donors"** (ss. 149.1 (1), (2), (3), (4), (5), (6))

Under s-s. 149.1 (2), charities that are "components of the same religious denomination" are excluded from the definition of "related charities". This provision, while enabling a free flow of funds from one religious charity to another within the same denomination, is unclear in many respects.

Since the phrase "religious denomination" is not defined, the type of organization contemplated and the extent of the exemption is difficult to determine. For example, several charities formed under the banner of a particular "denomination" have as their primary function education or health and social services. One wonders whether such a school or hospital would be subject to the related charity rules if it received contributions from an affiliated organization of the same religious denomination.

Charities of different religious denominations will be found to be related if any one of the conditions set out in paras. 149.1 (2) (a)-(d) is met. Each one of these conditions and the Centre's concerns about it will be dealt with separately.

Under para. 149.1 (2) (a), if "major donors common to both charities have contributed, in the aggregate, not less than 10% of the fair market value of all gifts made to each of the charities up to and including that time," the recipient charities will be related.

The definition of "major donor" found in para. 149.1 (1) (b) includes a person who has contributed more than 10% of all gifts received by a charity after December 31, 1982, and there is a danger that certain entities might be unintentionally included in this definition. Such entities might include Governments making grants that could be classified as gifts to charitable organizations, or non-resident charities making substantial gifts to two or more Canadian charities, thus resulting in the Canadian charities being related to each other and in one or both being related to the non-resident charity.

"It is even conceivable that a Government, Federal, Provincial or Municipal, could qualify in some cases as a major donor, a situation which was surely not intended by the draftsmen of the proposals."

Toronto Seminar

Under para 149.1 (2) (a), a charity will be required, before accepting a sizeable gift, to determine whether a prospective donor has made gifts to other charities that total at least 10% of the gifts received by them. Forcing recipient charities to question their benefactors in this way is hardly in keeping with the spirit of charitable giving, and, in addition, the information itself may be difficult to obtain from a benefactor who wishes to retain his privacy.

"If a foundation must disclose to a charity the percentage of its total donations in that year so that the charity can determine if they are to become related, or on the other hand, if a charity must indicate to a foundation how much has been received by other foundations, it could be considered an invasion of privacy."

Montreal Seminar

Paragraph 149.1 (2) (b) provides that charities will be related if "one charity was created or established to further the purpose of the other." It is common practice for both charitable organizations and foundations to set up parallel organizations in order to carry out long-term projects, act as public fund raisers or even, in the case of hospitals, prevent Provincial Government encroachment on privately donated funds. Similarly, most national charities have Provincial chapters that are responsible to the policy-making national entity but have separate registrations for income tax purposes. The fund-raising efforts of the Provincial chapters support the national organization, which is responsible for the disbursement of funds. If the proposed related charity rules are enacted in the manner set out, the national organization will be forced to expend, in the year of receipt, 100% of the funds received by it from the various Provincial chapters.

Where "one charity is at any time in the year a major donor of the other," the two charities will be related (para. 149.1(2)(c)). The definition of "major donor" discussed above is qualified to the extent that a charity will not be a major donor if it neither controls the recipient charity nor gives it more than 1/3 of all of its gifts in a particular year (para. 149.1 (1) (b)).

While this provision may not create a problem for larger charities, smaller charities receiving substantial funding for long-term projects could unknowingly end up "related" to a donor. Where the recipient cannot make use of the funds in the year of receipt, as may occur where it carries on research over a period of several years, the recipient may be unable to meet its disbursement quota.

"The new rules that would "relate" charities, otherwise unconnected, when one made a major gift to another, were of particular concern. The ramifications of such a relationship would be that the recipient charity would have to spend the money in the same calendar year it was received, which could be impossible if a gift were received late in the year."

"Why charitable foundations must wait,"
Financial Post, April 30, 1983

The term "control" is contained in the definition of "major donor," but the proposed legislation does not set out the circumstances under which one charity will be deemed to be "controlled" by another. (Subsection 149.1 (10), however, deals with control of a corporation by a charity, and s. 256 of the Income Tax Act, while not defining the word, refers to it in the context of determining whether corporations are "associated" for income tax purposes.) Control usually rests, in the case of registered charities, in the Board of Directors. The intended meaning of the word in the context of these legislative proposals should be clarified.

In addition, while gifts out of capital do not form part of the disbursement quota of a registered charity, the amount of those gifts will still be relevant in determining whether a particular donor is a "major donor" and thus related to the recipient. (Similarly, where substantial gifts out of capital are made to more than one recipient, para. (a) might operate and result in the recipients being related.)

Charities will also be related if "at any time in the year one charity did not deal at arm's length with the other" (para. 149.1 (2) (d)). The phrase "arm's length" is defined in s. 251 of the Income Tax Act and not only includes relationships between individuals, and between individuals and corporations, but also, according to Revenue Canada's Interpretation Bulletin IT-419, applies to trusts and partnerships. However,

since Interpretation Bulletins do not have the force of law and the term "charity," as defined in para. 149.1 (1) (a), includes a "foundation, association, trust or other organization, whether or not incorporated ... ", the definition of "arm's length" contained in the Act may not apply to unincorporated charities. This issue also requires clarification.

The Centre's concerns relating to the concepts of "disbursement quota", set out in para. 188 (1) (b), and "qualified disbursements", set out in para. 188 (1)(d), are discussed below. However, it is important to note that the application of the two terms could cause significant problems to related charities. In calculating its disbursement quota, a charity must include gifts (other than certain gifts of tangible capital property and gifts out of capital) received from a related charity. Further, a charity's qualified disbursements include the difference between the amount given to and the amount received from related charities in the year (capital gifts excluded).

Thus, where a charity that receives a gift from a charity that is a "major donor" is unaware of this status and proceeds in good faith to distribute the amount to another charity, thereby unknowingly becoming a major donor itself, it will not have made a "qualified disbursement" and may be exposed to a penalty tax on any shortfall.

In a recent proposal made to the Department of Finance by the United Jewish Welfare Fund of Toronto, it was suggested that the distinctions among the three types of charities be maintained, the concept of "related charities" be eliminated and only private foundations be required to include in their annual disbursement quotas 100% of all gifts received in the year from other charities. This proposal would eliminate much of the complexity contained in the amendments and is premised on the belief that the abuses at which the changes are aimed are committed almost exclusively by private foundations.

> The Fund goes on to recommend that, at the very least, if the concept of "related charities" is to be maintained, the definition of "major donor" be based on the present distinction between public and private foundations. A public foundation is now defined in sub-para. 149.1 (1) (g) (ii) of the Income Tax Act as "a charitable foundation ... of which not more than 75% of the capital contributed or otherwise paid in to the foundation has been so contributed or otherwise paid in by one person or by a group of persons who do not deal with each other at arm's length." The Fund recommends that this criterion be used to define a major donor, and that the definition of "related charities" in para. 149.1 (2) (a) be correspondingly amended, so that the relevant percentage would become 75%.

In the Centre's opinion, the possibility of abuse through the passing of funds from one charity to another, usually arises in situations where control is exercised by one charity over another and such abuse generally, although by no means exclusively, occurs in the private foundation field.

RECOMMENDATION: **The definition of "related charities" is too broad. The concept should be restricted to situations in which one registered charity is deemed to control another or where two or more registered charities are clearly controlled by one person or a group of related persons, either through the charities' members or through their Boards of Directors.**

9. **Disbursement Quota** (ss.188 (a), (b))

The Centre foresees a number of potential problems in the method by which a charity's disbursement quota is to be calculated. These problems are best illustrated by the use of specific examples.

Life insurance policy

Where a charity is the beneficiary of a life insurance policy paid for by the insured by annual donations, or where a charity owns a deferred annuity contract, the policy or contract will be valued at its cash surrender value, and 4-1/2% of this amount will form part of the charity's disbursement quota, even though the charity will in fact not receive any money until some later date.

RECOMMENDATION: **The treatment of such policies and contracts should be consistent with that accorded future interests in real property, which are valued at nil until the property actually comes into the charity's possession.**

Deferred annuity contract

Conversely, in the case of deferred annuity contracts, a charity will have future obligations.

RECOMMENDATION: **The present value of those obligations should be treated as a deduction from the value of the charity's investments for the purpose of determining its disbursement quota.**

Capital property no longer used in administration or charitable activity

Under cl. 188 (1) (b) (i) (A), taxable capital property used directly in charitable activities or administration is excluded from the disbursement quota. However, once the property is no longer used in that way, its value must be taken into account in determining the disbursement quota, and this may create unnecessary hardship in

certain situations. For example, where rural property, once used by a charity for a summer camp, is no longer so used and cannot be sold immediately, the charity, while receiving no income from the property, must include its value in calculating the disbursement quota.

RECOMMENDATION: **In order to permit orderly disposition, a charity should be allowed to apply for permission to exclude the value of such property from its investment assets for a specific period of time.**

Long-term research grants

Since research grants are often expended over a number of years, difficulties may arise in matching the timing of receipts and expenditures in order to meet the disbursement quota.

RECOMMENDATION: **Greater flexibility in the proposals would assist in smoothing out fluctuations over a number of years.**

"If John Smith gives ten thousand dollars to be kept for the benefit of retiring priests and there is no limit on the donation, it would appear under the proposed rules that such a donation would be included in the church's disbursement quota and 80% would have to be distributed. That is not, however, the intent of the donor. The intent of the donor is that the ten thousand dollars be used on a use-as-needed basis, at the discretion of the board of directors of the church. It is our feeling that such special purpose contributions should be considered as part of a charity's capital, not subject to the 80% disbursement requirement."

Toronto Seminar

Loans

Another area of concern involves the treatment of loans and loan payments. Included in the proposed calculation of a charity's disbursement quota are both amounts borrowed in connection with charitable activities or administration and amounts received as repayment of loans. Similarly, qualified disbursements are to include any amounts lent by a charity as part of its charitable activities or administration and any repayments made on borrowed funds.

RECOMMENDATIONS: Although the legislation does not make an exception for loans made by a charity before the proposals come into effect, it is the Centre's position that, where a loan was made prior to the effective date of the new rules but repaid after their implementation, the amount of the repayment should not be included in the disbursement quota. It is assumed that interest received with loan repayments is not to be included in the disbursement quota.

Similarly, interest-free loans made by individuals whose donations exceed 20% of their income should not form part of the disbursement quota, since they are intended to be repaid or forgiven as an endowment gift to be retained indefinitely as part of the charity's capital funds. Further, a loan made out of capital should be excluded from these provisions.

To use the example set out by the Department in its Discussion Paper (at p. 8) of a hospital corporation that borrows funds to finance the construction of its building, the Centre would propose that, in the year of construction, the qualified disbursement consist of the amount by which the cost of the building exceeds the loan proceeds and that future loan repayments be treated as qualified disbursements

for the years in which they are made, to be set off against donations received in those years.

Liabilities

The proposed legislation does not provide for the deduction of a charity's bona fide debts from the value of its investments in determining its disbursement quota. This is, in the Centre's view, a serious oversight. There are numerous types of debts and liabilities incurred in the ordinary course of business, such as rent, hydro, etc., which should be deducted in determining the value of the charity's investments.

RECOMMENDATION: **A charity should be permitted to deduct all bona fide debts and liabilities in determining the asset value upon which its disbursement quota is to be calculated.**

Excess disbursements

The proposals provide that the amount by which qualified disbursements exceed a charity's disbursement quota may be carried forward and offset against future deficiencies.

RECOMMENDATION: **A carry-back provision should also be introduced in order to avoid the imposition of penalties for prior deficiencies.**

"Under the proposed changes, charitable foundations, as we now know them, will be allowed to spend less than they have in the past and charitable organizations will be required to spend more."

Montreal Seminar

---

10. **Accumulation Rules** (ss. 149.1 (8), (9))

Under the proposed s-s. 149.1 (8), property may be accumulated, with Ministerial approval, for a particular purpose and the amount accumulated treated as a qualified disbursement. Although Department officials have indicated that income earned on this accumulated property is to form part of the authorized accumulation, provision for this automatic inclusion does not appear to have been made.

Further, the purposes for which Revenue Canada will permit an accumulation are generally limited to "bricks and mortar" projects. This is too restrictive, as many charities need to set aside funds for equipment replacement, general repairs and renovations to capital property and other contingencies for which it is not possible to set specific time periods for use.

RECOMMENDATIONS: **The legislation should clarify that income earned on accumulated funds may be included in the authorized accumulation and Revenue Canada should expand the purposes for which an accumulation will be permitted.**

11. **Qualified Disbursements** (s. 188 (1) (d))

Qualified disbursements have already been dealt with to some extent above, in the contexts of related charities and disbursement quota. They include, under para. 188 (1) (d) (i), both outlays on charitable activities and overhead and administrative expenses related to those activities but exclude fund-raising, investment and general administrative expenses.

In addition, under para. 188 (1) (d) (ii), qualified disbursements will include certain gifts to "qualified donees". The Centre understands that the omission of "related

administrative expenses" in para. (ii) was an oversight on the part of the Department and that this provision is to be amended to include such expenses.

"The 80 per cent rule is discriminatory and punitive to new organizations. It does not take into consideration the substantial start-up costs required in the first phase of activity. A new organization, for example, which initiates a fund-raising campaign will have dramatically higher costs than organizations with established fund-raising programs. Just to build support will necessitate an investment and, in fact, in the first year the amount donated will often equal the amount invested. As relationships with donors become more secure and the organization gains credibility, the overall costs of renewing support will decline significantly. The only reason the 80 per cent rule works is because it is not enforced. The new proposals only exacerbate the situation."

Consultant, Toronto

RECOMMENDATION: **It must be recognized that new charities are likely to incur fund-raising expenses in excess of the 20% limitation and the Centre recommends that the Department find ways to provide relief in such cases.**

12. **4.5% Rule** (s. 188 (1) (b) (vi))

Under this provision, 4.5% of the value of a charity's investments at the beginning of the year (after certain adjustments) is to be included in its disbursement quota. Reputable studies, such as the one commissioned by the Centre and entitled "Endowed Charitable Foundations in Canada", have demonstrated that an investment portfolio would be unable, over the long term, to maintain the real value of its assets while meeting the 4.5% disbursement requirement. The implementation of this proposal would therefore lead to an erosion of the real value of endowed funds owned by Canadian charities and to a distortion of the trustees' investment decisions.

If charities are to be protected against inflation, the most equitable method would be a variable disbursement quota percentage, tied to the rate of inflation. The Centre recognizes, however, that since a variable rate is impracticable, a fixed rate that is more in line with real long-term rates of return would be the alternative.

"The 4.5% capital base represents too great an annual amount to be added to the disbursement quota. It would not allow foundations to preserve capital and would certainly not permit any accumulations; in fact, it would have the adverse effect of eroding it over a period of time."

Winnipeg Seminar

"The underlying factor which determines the effect of government-imposed minimum disbursement requirements on the Foundation's desire to maintain long run viability is the real rate of return which may be earned on investment assets. Although nominal returns may look impressive, these returns must be inflation-adjusted to yield real returns. For example, if the nominal return to a portfolio is 10% and inflation is 6% then the real return is only 4%. However, if inflation is 12% then this 10% portfolio has lost 2% of its real value.

• • •

"It is only in the last few years that we have started to realize that real returns to investment are very small. The real returns to fixed income securities have, historically, been negligible while those to risk bearing equity no higher than 3% to 4%. Accordingly, it is suggested that a minimum spending rule in the neighbourhood of 3-1/2% is the largest that should be contemplated."

David J. Fowler, C. Harvey Rorke, Endowed Charitable Foundations in Canada: A Study of Spending and Investment Strategies Under Revenue Canada Regulations (Toronto: The Canadian Centre for Philanthropy, 1983), pp. i, 125.

RECOMMENDATION: **The required rate of disbursement should be reduced to 3.5%.**

13. **Rate of Return on Non-Qualified Investments** (s.149.1 (1) (c))

While the Centre fully supports the concept of a mandatory minimum return being attached to non-qualified investments, numerous foundations have indicated that they will have difficulty with a fluctuating minimum rate of return.

RECOMMENDATION: Because of the many complexities involved in this area, the Centre recommends that it be subject to further study.

14. **$250,000 Threshold** (s.188 (1) (b) (vi))

The $250,000 threshold under which, in most cases, a charitable organization would be required to commence calculation of the 4.5% disbursement requirement on investments will create an anomaly whereby a charitable organization with $250,000 in invested assets will be required to expend $11,250, while a similar charitable organization with invested assets of $249,999 would have no disbursement requirement.

RECOMMENDATIONS: The quota should be based on a percentage of invested assets in excess of $250,000, with the first $250,000 being exempt. Additionally, this amount should be indexed for inflation.

15. **Related Business** (s. 149.1 (1) (f))

A related business is defined as "a business that is related to the objects of a charity and includes a business that is unrelated to its objects if substantially all of the people employed in the carrying on of that business are not remunerated for such

employment." The earlier definition of "related business" has been modified to the extent that those employed in the unrelated business enterprise may not be remunerated for their services either by the charity itself or by any other person.

This modification will make it effectively impossible for charities to continue to operate many necessary businesses. For example, if a large corporation provided the services of one of its executives to a charity's unrelated business activity and continued to pay his salary, the activity would not be a related business, under para. 149.1 (1) (f).

A significant problem lies in the definition and adjudication of what will constitute a non-related business. Some areas in which difficulties could arise under this section might include the operation of a parking lot, the sale of excess time on a charity-owned computer, a cafeteria that served participants but was also open to the public, a book store, or the rental of unused facilities by a university during the off-season.

"We have some concerns about ancillary activities and particularly those quasi-business operations such as high-tech development and/or research on a contract basis. A number of universities are now involved actively in these arrangements and we're not at all sure how they should be dealt with given the new proposals. It is also not entirely clear how to deal with a school that provides its own factories as part of its total education experience. How would this profitable activity be dealt with under the proposals?"

Toronto Seminar

Most charitable organizations continue to operate successfully and productively largely because of the commitment and dedication of volunteers and staff to "a cause", diligence in seeking varied sources of revenue and a sympathetic tax system,

which traditionally has sought to encourage voluntary giving. However, too many Canadian charitable organizations are increasingly facing more severe financial difficulties, partially as a result of declining United Way support and other contributed incomes. The corporate community and some Provincial Governments continue to encourage charities to become more self-sustaining by establishing a higher degree of business orientation and adding a profit-making component to the operation. The proposed restrictive regulations governing non-related business endeavours will tend to discourage or eliminate this alternative, thereby placing the financial future of many charities in extreme jeopardy.

RECOMMENDATION: **The regulations allowing unrelated business activity to be included as related activity should be revised to permit remuneration, provided the activity has some identifiable relationship to the objects of the charity.**

16. **Control of a Business Corporation** (s. 149.1 (7) (c))

The draft legislation prohibits the acquisition of control of a corporation by a charity after May, 1983. In effect, this extends to charitable organizations the prohibition that has previously applied only to charitable foundations. The penalty for contravention is revocation of the charity's registration.

These new provisions come at a time when a number of charities, particularly universities and hospitals, have set up or are seriously examining the possibility of setting up private corporations for the purpose of carrying out contract research or benefitting from the technology arising from research they have been conducting. Such a move on the part of charities is surely to be welcomed, indicating as it does a resolve to tap new sources of revenue and to ensure that practical applications for

their research are speedily developed. Indeed, some Provincial Governments have been urging hospitals to take this step and, more generally, universities have been coming under considerable pressure from Governments to make themselves more useful to their communities. The proposed legislation would effectively halt the fostering of such business-oriented operations by charities.

Additionally, these corporations will be classed as "non-qualified investments" and will be required to pay to the charity a minimum rate of return on the charity's investment. It is highly likely that those corporations that have recently been established will not yet be operating at a profit, if indeed they ever will. Not only is there no prospect that they can meet the required rate of return but, at least in some cases, Provincial legislation forbids companies operating at a loss from paying a dividend. This is yet another context in which the proposed legislation reflects an intention on the part of one level of Government that is diametrically opposed to that of the other.

The Centre accepts the position that there is a potential for abuse in the relationship between a charity and a "for profit" corporation. This is particularly evident in the case of charitable foundations. Recognizing the distinction between foundations and organizations in the legislation would, of course, enable differentiation in the legal regimes covering each entity.

"There is a dichotomy between the programs that are being put forward by Queen's Park and those proposed by Ottawa. The federal proposals would prohibit the acquisition of control of a corporation and yet Provincial Governments, not just in Ontario, but apparently in a number of other provinces as well, have made it a condition of certain fund raising that certain activities be carried on through profit corporations, particularly the B.O.N.D. projects. If this were to continue it would result in automatic deregistration under the federal proposals."

Toronto Seminar

The provision in the proposed legislation governing control of a corporation by a charity reflects a serious misunderstanding of how large charitable organizations function. They are complex entities, akin in many important respects to big businesses, and needing the same scope for their natural development. The manner in which they serve society has now evolved to the stage at which they are accepting the challenge of developing and marketing Canada's technological expertise. This is bound to require new forms of corporate organization appropriate to their expanded tasks. It is exceedingly important, therefore, that the Government's tax regime enable charities to undertake business-oriented developments that accord so well with emerging national priorities.

RECOMMENDATION: The legislation should include a provision whereby a charity could apply for Ministerial permission to control a corporation set up by it to extend the benefits of its charitable activity.

17. Deadline for Annual Filing (s. 149.1 (11))

The deadline for the filing of annual information returns is to be increased from three months after the charity's fiscal year end to four months. In the Centre's opinion, this time period is still inadequate. Most charities are unable to offer their accountants more than a charitable rate of compensation and, as a result, are generally not in a position to have their audits completed until several months following their year end. It is therefore unreasonable to expect that a four-month deadline will be met by a greater proportion of charities than are able currently to meet the three-month deadline.

"If the Government is prepared to allow a six-month period after the close of the fiscal year for an ordinary business corporation, then, surely, some time limit at least equivalent to that should be allowed for a charitable organization or foundation, particularly in the case of those charities that depend upon the volunteer assistance of chartered accountants."

Toronto Seminar

RECOMMENDATION: **A deadline of six months, in the Centre's view, would be reasonable and fair, given that a similar deadline is imposed on other corporate organizations under the Income Tax Act.**

18. Gifts to Non-Residents (s. 149.1 (1) (d))

A Canadian charity is allowed to make donations to those charitable endeavours outside of Canada which have received donations from the Government of Canada in

the preceding 12 months, to the United Nations and its agencies and to prescribed foreign universities.

The charity is able to transfer funds for overseas work only if it arranges to carry out the work itself or if another Canadian charity does so on its behalf. The Canadian charity may utilize an agent for its work, but must retain control over the transferred funds. Canadian charitable funds therefore may not legally be sent to a Third World partner or to an International Headquarters where operational decisions on the use of the money are made. Further, it appears that no money may be spent on land, buildings or capital equipment unless title is held by the Canadian charitable organization.

"A charity that carries on activities in a foreign country normally must be in a position where it can state to Revenue Canada that it is controlling those activities. However, this goes against the grain in a lot of areas where one of the goals of the program is to make the operation in the host country self-sufficient. There has been nothing addressed to this problem of operating through agents or local groups."

Calgary Seminar

Where the foreign activities of a Canadian charity are conducted with the financial assistance of the Canadian International Development Agency (CIDA), problems may arise in matching qualified disbursements with the charity's disbursement quota. A longer period for averaging these amounts would be required. What CIDA clearly encourages, therefore, is, according to Revenue Canada, in contravention of the Act. It therefore seems clear that all Canadian charities, including churches, supporting programs in foreign countries have acted (and will continue to act under the new proposals) in contravention of the Income Tax Act.

RECOMMENDATIONS: Paragraph 149.1 (1) (d) should be expanded to permit the disbursement of funds to overseas charitable activities, where the funds are used for such purposes as humanitarian, technical or professional assistance, social, educational, economic, institutional or organizational development, or financial support of an international headquarters. Further, the administration of the funds in the foreign country should be undertaken either by the Canadian charity or its agent or by a recognized charitable organization in the foreign country. This area is not dealt with in the Discussion Paper and requires substantial further study and consultation.

III CONCLUSION

Very substantial improvements are needed in the present draft legislation if it is to serve the stated aims of the Department. In its existing form, the legislation will place a completely unnecessary straitjacket upon the 47,000 organizations that constitute the backbone of Canada's voluntary sector.

In the view of the Centre for Philanthropy, the key to reform of the present draft legislation is abandonment by the Departmment of the proposal that the three classes of charities in Canada be subject to a single, integrated set of rules. This reform along will not, however, resolve all of the problems, as we have attempted to illustrate.

Much will have been learned from the long process of negotiation and consultation that started with the November 12, 1981 Budget Resolutions. It is important, however, that, even after the amendments are enacted, there be continued and

improved communication and consultation between the Government Department charged with the regulation of charitable activity through the tax system and the 47,000 organizations throughout Canada that do the community's work.

"It appears that what we have here are the professional persons, professional administrators of charities, professional advisors of charities, and some volunteers - generally people who are quite knowledgeable and are taking the opportunity today to become more knowledgeable in matters that are going to affect them. When I think of all the smaller charities that rely wholly or almost wholly on voluntary activity that are not represented here, and the pitfalls and problems that they're going to face, I think their problems are going to be even more severe. So, we haven't heard from the whole charitable world yet, and the concerns that are raised here are indicative of what's going to be heard when more people begin to realize how they are affected."

Halifax Seminar

The problems illustrated herein, far from being esoteric or rare, are both substantial and widely applicable. While not all affected parties have as yet spoken out, this is due, as noted in the Introduction, to the failure in dissemination and the very complexity of the proposals. It would be erroneous to conclude that silence in this case amounts to consent. Were the May 17, 1983 proposals to be enacted into law in their present form, the problems would begin in earnest, the protests would accumulate accordingly, and charity in Canada would suffer substantially.

The best feature of the Discussion Paper is that it is just that, a paper upon which further discussion can be based. There is still time to improve the methods by which to accomplish the intended goals. Let us proceed.